Islamic Banking

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I. INTRODUCTION

With an increasing number of cultural minorities in the West, and the growing importance of emerging markets, banks need to pay more attention to cultural differences. Traditional banks that want to continue doing business with Muslims in the future should change radically, since certain common bank transactions are illegal for Muslims. Examples are speculative transactions or interest-based transactions. In the past, Muslims had no alternative for traditional banks. With the appearance of Islamic banks, Muslims now have that alternative. In this article, I present an overview of the theory of Islamic banking (section III), and its implementation in practice (section IV). I will, however, begin with a section about the Islamic Revival, the roots of the Islamic banking movement, and a short subsection about Islamic Law.

II. THE ISLAMIC BANKING MOVEMENT

A. The Islamic Revival

With the end of World War II, the curtain soon fell on the Colonial Period. For the first time in many centuries, large parts of the Islamic world were no longer governed by a Western-Christian regime. When the Cold War started, most of the newly independent Muslim states chose a mixed policy of nationalism and socialism. But, with the failure of the Socialist experiment, the aversion against Western and other alien socio-political concepts increased. This gave a strong impulse to the Orthodox Islamic-revival movement, also known as "Islamism". Islamism has been in the ascendent since the end of the 19th century. Islamists claim that the Islamic world can only be free and prosperous if it is transformed into a truly Islamic society, free from non-Islamic elements.

Islamists therefore turned their attention to every aspect of society in order to root out all non-Islamic elements. Islamist scientists proposed Islamic alternatives to the legal system and the economy. Instead of the Marxist planned economy and the capitalist economy, concepts strange to Islam, an economic theory based on the Shari'a was developed, called Islamic economics.

B. Shari'a, the Islamic Law

The Shari'a is not a codified law. It is an abstract form of law, embodied in millions of edicts from judges and scriptural writings of scholars. The Shari'a developed through different schools of law. Nowadays, four schools of law still exist. They agree on the main subjects, and mutually recognize each other. The Shari'a is based on four main sources of law: the Quran, the Traditions of the Prophet and his most faithful companions, the consensus of all Islamic scholars, and deduction by analogy. For a further discussion of these sources of law, see Schacht (1964).

The tenth and the eleventh century A.D. were the Golden Age of the Islamic empire. Islam led the world in almost every field: in power, in social refinements, in literature, architecture and philosophy. The Empire reached from Northern Spain to Western India. No wonder that Muslims saw this as a sign from God that their leadership was truly Islamic. And when the most important questions of law were answered, consensus was reached within the Muslim community that the wisdom of the Islamic scholars and leaders of the first generations could never be surpassed. Therefore, future generations had to conform to the rulings of the first generations. No free, independent development ("Idjtihad") of new concepts within Islamic law was permitted any more, except on minor issues. To solve problems, a Muslim should always first refer to one of the solutions developed by earlier generations. Muslims could resort to new techniques and instruments as long as these did not conflict with explicit prescriptions or with the more general principles of Islam. Further on, we will come to see how this ban on the development of major new concepts of law has influenced Islamic economics.

C. The Rise of the Islamic Banking Movement

With the rise of Islamism, opposition against the Western, interest-based banking system grew. The first thorough studies devoted to the establishment of an Islamic bank appeared in the 1940s. In the forties and fifties, several experiments with small Islamic banks were undertaken in Malaysia and Pakistan. The first great success was the establishment of an Islamic bank in the Egyptian village of Mit Ghamr, in 1963. Other successes include the establishment of the inter-governmental Islamic Development Bank in Jeddah in 1975, and of a number of commercial banks such as the Dubai Islamic Bank, the Kuwait Finance House and the Bahrain Islamic Bank, in the seventies and eighties. At the same time, the banking system in Iran and Pakistan was 'Islamised' to a

large extent. From the second half of the eighties, however, conditions became less favourable for the Islamic banking movement, and the number of new Islamic banks began to decrease. Nowadays, there are about 170 Islamic financial institutions (not only banks), with assets totalling US$ 137 billion (Euromoney, 1998). Not only do they exist in traditionally Islamic countries, but also in the United States, United Kingdom and Switzerland. Furthermore, many 'traditional' banks offer Islamic services to their Muslim clientele. The Islamic banking sector is still small, but for a relatively young sector it has performed well.

This section has briefly treated Islamic Law, the rise of Islamism, and the emergence of the Islamic banking movement. A discussion of the theory of Islamic banking will follow below.

III. THE THEORY OF ISLAMIC BANKING

A. What is Islamic Banking?

There is a plethora of differing views about the definition of Islamic banking. In my own view, Islamic banking is "... a form of modern banking based on Islamic legal concepts developed in the first centuries of Islam, using risk-sharing as its main method, and excluding financing based on a fixed, pre-determined return".

How does an Islamic bank differ from a non-Islamic bank? First of all, in its mission and objectives: because Islam is the backbone of Islamic banking, moral principles and objectives play a more important role in the operations of an Islamic bank than in a non-Islamic bank. Second, in its products: an Islamic bank offers no interest-bearing products or services, for example, and is more oriented towards risk-sharing products. Third, in its organisational structure and corporate governance: Islamic banks have an Islamic (religious) board, to ensure that the bank's practices are in line with the Shari'a, and a strong social solidarity division. Because of these elements, Islamic banks have the characteristics of investment banks, commercial banks and development banks.

B. Seven Principles of Islamic Economics

Contrary to positive (value-free) economics, Islamic economics are clearly normative. The Islamic values are reflected in Islamic economic principles. For this article, I selected seven of the most important of these economic principles. From these abstract principles two more concrete Islamic economic rules will be derived. Finally, based on these rules, two "contracts" will be discussed which can be used by Islamic banks to attract funds and provide financing in a truly Islamic way.[1] Beginning with the seven principles, moving on to the two rules, and ending with the two contracts, we move from abstract theory to daily practice. But let us start off with the seven main Islamic economic principles:

1. ***Justice, equality and solidarity***
   For many Muslims, these concepts are the essence of Islam. In the field of economics, they require that business should be conducted in an honest way. This precludes, for example, monopolisation, or abusing the ignorance of an inexperienced partner. Solidarity is encouraged by promoting almsgiving as a noble deed, and by the duty of each Muslim to pay zakat, a tax on wealth (usually about 2.5% of personal wealth).

2. ***Forbidden objects and creatures***
   Islam classifies certain objects or creatures as unclean (for example, pigs) or even forbidden (e.g. fortune telling books based on astrology). Such things cannot be the object of a legal transaction. Furthermore, certain objects are clean but not tradable, such as the soil of holy places. The number of prohibitions is extensive and unsystematic.

3. ***Acquisition of property rights***
   Property may be acquired in the following three ways: a) new rights can only be legally created by combining one's labour (including 'spiritual' labour) with natural resources. 'Old' rights can be transferred, either b) in exchange for a counter value of the same worth; or c) as a **voluntary** gift/inheritance.

Interest is not a legal form of property, because it is not acquired in one of the three legal ways: Islam does not consider lending or postponement of consumption as labour. Furthermore, interest is neither exchanged for a counter value of the same worth, nor given voluntarily.

4. ***Property (wealth) should be used in a rational but fair way***
   Islam rejects unproductive hoarding as wasting money. Wealth is a blessing of God, but not an end. It should be spent, but always in a responsible way. Property rights should not be used contrary to the interests of the community.

5. ***No gain without either effort or liability***
   According to Schacht (1964, p. 145), 'receiving a monetary advantage without giving a counter value' is forbidden. Islam is not opposed to profit or financial gain, as long as:
   a. an effort is performed, or (partial) liability is accepted for the financial result of a venture (in the case of a financier); and
   b. the effort or venture was productive, i.e. it led to an increase of value; and
   c. the profit was made in an honest manner, in line with the Shari'a.

According to Islam, money is sterile, as long as it is not combined with (spiritual) labour, "property does not breed property" (similar ideas can be found in Aristotle). Therefore, the mere postponement of consumption (saving) is no justification for a compensation (interest). Without investment, saving does not produce any additional value. If someone borrows money and consumes it, according to Islam it would be unfair to reward the lender, because no value was added with the money.

If, however, the money is used for productive ventures, it can yield financial gain. Because this gain would have been impossible without the investor, it is logical and just that the profit should be shared with him. If there had been only losses, his money would be at stake. This liability entitles him to a share in the venture's result that is not a fixed one, but a predetermined **share** of the financial result. Contrary to this, in the case of interest-based financing, a venture could be extremely profitable, and still yield only a small reward for the lenders. On the other hand it could generate high losses, but the lenders would still receive a reward. Islam considers this unfair, and that the reward of investors should be tied to the result of the investment. This idea is called 'profit and loss sharing'.

6. General conditions of credit

a. Debtors in financial distress should be treated leniently. If the debtor is not able to pay back the principal, he should be given a delay without a penalty. Even better, the debt could be remitted.
b. There are diverging views about the lawfulness of different credit and spot prices. Opponents claim that the difference between credit and spot prices is nothing more than an implicit interest rate. Others claim that it is allowed for commodity transactions, but not in financing (when only money is involved).

7. The duality of risk

Islam has a dual conception of risk. On the one hand, it considers the partial acceptance of liability (for risk) in a productive venture as a legitimation for a share in profit (principle no. 5). On the other hand, risk should always be taken cautiously. Excessive, uncontrollable risks or uncontrollable obligations should be avoided. For example, the sale of an object which the seller does not yet possess is illegal. Furthermore, gambling or speculation are forbidden. Finally, uncertainty in the obligations of contracting parties is forbidden. The object of a contract must be "... known, ascertained and in existence" when the contract is concluded. The difference between legal and illegal risk is not always easy to determine, therefore, in concrete cases, an expert in Islamic law should be consulted.

The essence of principles is that they are general, and not very concrete. Therefore, Islamic scholars deduced from these principles more concrete economic rules for economic behaviour. Two of the most relevant will now be discussed.

C. Rule I: the Prohibition of Riba[2]

"Riba has seventy segments, the least serious being equivalent to a man committing adultery with his own mother", a Tradition of the Prophet Muhammad, narrated by Abu Hurairah (Haron and Shanmugan, 1997, p. 55)

The first rule is the prohibition of Riba. Islam clearly prohibits Riba as a great sin, comparable to murder, fornication and idolatry (Juynboll, 1930). But what is Riba exactly? Two views can be distinguished, the Modernist and the Orthodox.

1. The Modernist View

The Modernist view focuses on the "morale rationale" behind the prohibition of Riba, to determine what Riba is and what it is not. The Orthodox view, which will be discussed further on, has a more legalistic, literal approach. Modernists claim that the underlying reason for the prohibition of Riba is to prevent injustice and to protect the less well-off from the exploitation of their need. According to this view, Riba is more than interest, and not all interest is Riba. A certain rate of interest may be Riba if it is demanded from someone in great distress (who uses money to meet his basic needs), whereas it may not be Riba when it is demanded from a rich man, or a company (who use money in their trade or investments). In the latter case there is no question of exploitation. Since the Modernist view is a minority view, the rest of this article will be devoted to the Orthodox view.

2. The Orthodox View

The Orthodox view, the majority view among Muslims, focuses on the **literal** prescriptions of Islam. The underlying motives are less important. This makes the Orthodox view more vulnerable to legal tricks, such as fictitious transactions used to circumvent the prohibition of Riba.

In the Orthodox view, **all** interest is Riba, but Riba is more than interest. It is defined as "... a monetary advantage without a countervalue, which has been stipulated in favour of one of the two contracting parties" (Schacht, 1964). Riba exists in two forms:

1. Riba in sales.

A broad definition of sales is used here, including barter, forward buying and currency exchange. Riba in sales can occur only when so-called 'Riba goods' are sold. To generalize somewhat, there are three categories of Riba goods: foodstuffs, precious metals, and money. Within each kind, there may be numerous genera, such as dates, bread, rice within the category foodstuffs. Riba in sales occurs when Riba goods of the **same** genus (e.g.

Deutschmarks for Pounds Sterling, dates for dates, etc.) are exchanged in different amounts (where amount is defined as either number, weight or value, whichever is most relevant for that genus). This type of Riba of sales is called **Riba of excess**. There is a second type, **Riba of delay**, which occurs when one Riba good is exchanged for another, and the countervalues are **not** exchanged at the same moment.

Examples:
A silver plate with a material value of 1000 US$ is exchanged for a bar of silver with a value of 900 US$; 5 kilograms of ripe dates are exchanged for 8 kilograms of unripe dates (both **Riba of excess**), 10 loaves of bread are bought and exchanged, the price of 10 US$ is paid tomorrow (Riba of delay). For **Riba of delay**, both Riba goods do not have to belong to the same genus or category.

2. *Riba in debts occurs when interest in any form (either as money or as goods) is paid as compensation for a loan, unless it is not agreed on beforehand and is paid completely voluntarily. This form of Riba is prohibited as a consequence of principle no. 5, no gain without either effort or liability, where lending is not seen as either effort or the acceptance of liability*.[3]

D. Rule II: Profit and Loss-Sharing (PLS) and Three Important Types of Contract

If financing with a fixed return is not allowed, banks should finance on the basis of a flexible return. One of the possibilities is profit and loss-sharing (PLS), which also comprises equity-based financing. Within the Shari'a, it is the most prominent form of financing, therefore the second rule is that financing should be provided on the basis of PLS. Actually, interest-free loans (also excluding debt with an implicit interest rate, such as zero-coupon bonds), are another option, but not for large-scale financing. PLS is a form of partnership, where partners share profits and losses on the basis of their capital share and effort. The justification for the PLS-financier's share in profit is his effort or liability (principle no. 5). PLS-financing is an example of cooperation on the basis of equity and solidarity (principle no. 1). Overall, there are two main types of contract: D.I. PLS Financing Contracts and D.II. Non-PLS Financing Contracts.

D.I. PLS Financing Contracts

Islamic jurists have worked out two forms ("contracts") of PLS-financing: joint venture (musharaka) and trust financing (mudaraba).

1. Joint Venture (Musharaka)

Joint venture or limited liability partnership is intended to combine the talents of two or more partners in a business enterprise, while they share in both the risks and financial results. In a joint venture, partners contribute both capital and effort. Their contribution in capital or effort may vary, in which case they share the financial result on the basis of their share in capital and their effort. Since most banks do not wish to be actively involved with the management of a venture, this form of partnership is not common among Islamic banks.

2. Trust Financing (Mudaraba)

Trust financing or "commendam" is the partnership of a financing partner and a managing partner.[4] The financing partner entrusts his capital to the managing partner, who in his turn contributes his knowledge and entrepeneurial skills to the project. The financing partner is not involved in the actual management of the partnership. This makes trust financing the preferred form of partnership for banks. Profits are shared in a pre-determined ratio, and losses are borne by the financing partner, unless they were caused by the irresponsible behaviour of the managing partner. Partners agree on a pre-determined **share** of the result. The exact amount of profit they receive may not be fixed, because that would simply be interest in disguise. In the event of a loss, the financing partner bears the loss, while the managing partner loses his effort and time, and receives a lesser reward than in the case of a profit.

Equity financing and investment deposits with Islamic banks are examples of mudaraba: in the latter case, the depositors are the financing partners, whereas the Islamic bank is the managing partner. The bank actively invests/finances the deposits. The bank, in its turn, then becomes the financing partner, whereas the client receiving the bank's financing is the managing partner. Thus, a dual trust-financing relationship is the basis of an Islamic bank.

To sum up, Islamic economics advise Islamic banks to base their operations on PLS. However, as we will see in section IV.F, there are a number of practical disadvantages to PLS-financing. Therefore, most financing by Islamic banks is provided on a non-PLS-basis, by mark-up financing.

D.II. Non-PLS Financing Contracts.
Mark-Up Financing (Murabaha)

Mark-up financing, or cost-plus financing, is a form of trade financing. It starts with an agreement between a (final) buyer and a middleman, the trader. The final buyer asks the trader to buy a certain object for an agreed price. That price consists of the purchase price of the object, the costs of the trader and a certain profit margin. The final buyer uses the services of the middleman because he cannot or does not want to find the object himself, or because the trader can obtain the object on better conditions, or purely as a financing tool.

In spite of the previous agreement, Shari'a allows the final buyer, at any moment, to cancel the deal with the trader. This

could mean that the trader is left with an object which the final buyer asked him to buy. This may initially sound unreasonable to some readers, but the Islamic law allows it.

When Islamic banks play the role of middleman, it is mostly as a financier. Mark-up financing is then used as an instrument of credit. The bank only handles the documents involved, while the goods are shipped to the final buyer directly. Mark-up financing and other variants of trade financing are by far the most popular instruments of financing for Islamic banks. On average, more than 75% of all financing is provided on the basis of trade financing. Saeed (1996) mentions several reasons to explain its popularity. First of all, PLS-transactions usually require a medium- to long-term involvement of the bank, whereas mark-up financing is essentially a short-term transaction, thus reducing the bank's risks. Second, contrary to PLS-transactions, mark-up financing guarantees the bank a certain profit. It can be set at an equal level as the customary interest margin for comparable, interest-based transactions. Third, because the bank's risks are much more limited and their compensation already known, no detailed contracts have to be prepared to restrict the entrepreneur's behaviour.

Because traders want to minimise the chance that the final buyer may decide in the end not to buy the object ordered, modern mark-up financing deals are often concluded with two contracts. First, a promise of the final buyer to keep his word and buy the object he asked for. Second, the actual sale contract. This modern variant of murabaha is comparable to a letter of credit. Two contracts are needed because the Shari'a explicitly allows the final buyer to refuse the ordered object. It is more or less a legal construction to reach an end that the Shari'a does not allow: to restrict the final buyer's freedom to refuse the object in the last resort.

Despite its popularity, mark-up financing is the most criticised instrument within Islamic banking, too. Criticism focuses on the following points:

- The promise to purchase and the sale are illegal, they impose "uncontrollable obligations". The buyer promises to buy an object which he has not yet seen. Furthermore, the seller sells an object which he does not yet possess. Both are thus illegal (principle no. 7).
- If the credit price is higher than the spot price, a reward is, in fact, being paid for lending. This is Riba (El Ashker, 1987, p. 98).
- In practice, penalties are charged for late payment. However, the Shari'a requires the debtor to be allowed a delay (principle no. 6), and no penalty can be charged.
- Mark-up financing is a legal trick, an interest-based loan in disguise. Saeed (1996, pp. 89-90): "In both cases, it is a debt, and the cost of financing, whether it is called interest or profit, is fixed, and the time allowed for repayment is also fixed". The profit margin is agreed on beforehand and is almost certain, except for the risk of insolvency.

If there is so much criticism of mark-up financing as the main instrument of Islamic banking, why then is it so popular? The main cause is that mark-up financing does not suffer from the major disadvantages of PLS for banks. In the next section some of the disadvantages of PLS are treated.

Earlier on, seven important principles of Islamic economics were presented. Because of their abstract character, Islamic jurists derived two more concrete rules from them. The first rule is the prohibition of Riba. The second rule states that, because Riba is prohibited, the only legal basis for financing is PLS. Building on these rules, Islamic scholars designed two contracts of partnership for financing: joint venture and trust financing. In practice, however, Islamic banks mainly provide short-term mark-up financing (murabaha). Murabaha is, however, severely criticised as an instrument of Islamic banking.

IV. ISLAMIC BANKING IN PRACTICE

In section III, a theoretical framework for Islamic banking was built on seven principles, two rules and three types of contract. This section is concerned with the practical implementation of the theory. This will be done by discussing the implications for the main activities of a bank.

A. Collecting Deposits

Since interest-bearing deposits cause Riba of debt (see section III.C.2), Islamic banks offer two different kinds of deposit: current accounts and investment accounts. Current accounts are similar to those offered by conventional banks. The deposited capital is guaranteed and made available to the client at any moment. No reward is paid on deposits. They are mainly used for transaction and safety purposes.

Investment deposits must remain with the bank for a certain, previously agreed, period. Customers open investment accounts to yield a financial return. Investment accounts are based on trust financing. The depositor is the financing partner, while the bank is the managing partner. The bank pools all investment deposits and searches for suitable investment opportunities. The return on investment (positive **and** negative) is then shared with the depositors, after the bank has deducted its own costs and a previously agreed fee for its efforts. The type of investment account and the terms of the deposit determine a depositor's share in the investment's return. A higher share of profit is paid for deposits with a longer maturity. In the event the investment is not profitable, the depositors share the loss. Their maximum liability is the

deposited sum. Investment deposits can only be withdrawn prematurely by paying a certain fine.

B. Financing

Depending on the situation, Islamic banks can choose between PLS-financing, trade financing or lending. With respect to PLS, a client will first of all present a detailed investment proposal to the bank. The bank will then decide to participate or not. If it does, it will usually do so on the basis of trust financing, assuming the role of financing partner so as not to be involved with the actual management of the venture. The contract between the bank and the client should clearly stipulate the partners' responsibility and the profit sharing ratio. However, trust between both parties should prevail, so contracts should not be too restrictive and detailed. In practice, however, banks design extremely detailed contracts, thereby severely limiting the managing partner's freedom to act. Banks try to minimise all chances for abuse of their funds. Furthermore, in practice, banks sometimes use their dominant position to renegotiate their profit share during the project, for example if profits are disappointing. According to the Shari'a, the conditions of the contract can only be altered with the consent of **both** parties. Some banks even try to avoid liability for losses, which is completely contrary to Shari'a. The client should regularly report to the bank about the venture's progress, and should reveal all relevant information. In practice, however, entrepreneurs often inform the bank selectively, so as not to reveal sensitive information about their business. This illustrates that the ideal situation of mutual trust is seldom encountered.

With respect to trade financing, besides mark-up financing, other popular methods are leasing (ijara) and lease-purchase (ijara wa iqtina). In section III.D.3, we saw that, in practice, banks involved with mark-up financing limit the freedom of the final buyer to refuse an ordered object by requesting him to sign a contract of promise. Furthermore, these contracts impose uncontrollable obligations. Both elements are forbidden by Shari'a.

Lending is possible in the form of overdrafts on current accounts or interest-free loans. In practice, not all banks allow overdrafts, and some charge a fee for overdrafts, contrary to principle no. 6 (debtors should be treated with leniency). Regarding interest-free loans, there is no uniformity among Muslim scholars about the question of whether a bank is allowed to charge a fee to compensate for administrative costs and for bad loans, i.e. no profit is received for these loans, only a compensation for costs. Strictly orthodox scholars will, however, not agree with loans bearing a fee. In practice Islamic banks only provide costless loans for humanitarian and welfare purposes. After the agreed period, the debtor has to repay the loan, but in cases of financial distress, repayment may be postponed, in line with the Shari'a.

From the perspective of Shari'a, PLS-financing is the most desirable possibility and secondly lending. Only in cases in which neither of these are suitable should banks resort to trade financing. In this respect, there is a great gap between theory and reality: in practice, 70% or more of all financing is provided through trade financing, whereas PLS never makes up more than 30%, and usually much less (Ray, 1996; Wilson, 1990).

C. Trading in Securities

A bank may trade in securities for its client, and ask a fee for it. The legal basis for this in the Shari'a is the agency-contract. The fee, however, should be fixed and reflect the costs and efforts of the bank. Hence, it may not depend on the sum in transaction, unless the size of the transaction influences the bank's effort.

A number of securities are not acceptable according to the Shari'a: consequently Islamic banks may not deal with them. I differentiate between three types of securities: fixed income securities, stocks and derivatives. Fixed-income securities, such as certificates of deposit and zero-coupon bonds, are forbidden. They contain either explicit or implicit forms of interest, i.e. Riba in debts. Stocks are a legal form of trust financing. As with trust financing, dividends are normally distributed according to the capital-contribution ratio. In general, Islam has a positive attitude towards shareholdership and stock-markets. This holds good, of course, only within the legal framework of the Shari'a. Speculative trade in stocks, or shareholdership in forbidden sectors, such as breweries, are illegal. A majority of Islamic scholars also reject shareholdership in firms that are in any way involved with interest-based financing. Preferred stocks form a special case: owners of preferred stocks are promised a fixed cash dividend periodically. This is similar to interest, and therefore illegal. A feasible Islamic solution would be to issue preferred stock with a preference dividend based on a pre-determined ***ratio*** of profit.

There is still not much jurisprudence about the lawfulness of derivatives. For the purpose of this article, it would go too far to treat this topic in detail. I will confine myself therefore to briefly expressing my private view. Based on the principles of Islamic economics, I believe that commodity derivatives (commodity options, futures, etc.) are legal, as long as they are not used for speculation, and the Shari'a is observed. Financial derivatives (swaps, currency futures, stock options, warrants, etc.) are illegal, as they involve Riba.

D. Other Banking Services

The fourth category of bank activities comprises services like payment and clearing of cheques, money transfers, safeguarding of valuables, purchase and sale of foreign currency, and financial advice. The legal basis for these activities is the

agency-contract. Clients benefit from these services, and the bank has to incur costs to offer them. Hence, it is justified to ask a fee. When no extra effort is performed and no extra costs are incurred for repeated services, the bank cannot legally charge a fee. The fee must be proportionate to the effort and costs. It may not fluctuate with the size of the transaction, if size does not matter for cost and/or effort. Another important activity of banks is issuing letters of credit and guarantees. The legal basis for these transactions is the guarantee (kafala) contract. Earlier, we saw that liability (guarantee) is one of the justifications for a reward, so a fee may be asked.

E. Social Activities and the Religious Supervisory Board

Islamic banks have to incorporate both profit and morality into their objectives. Consequently, supporting social welfare programmes is a way of fulfilling their religious duty. Islamic banks finance social activities through the obligatory zakat (wealth) tax and through voluntary donations.[5]

In order to ensure that their operations conform to the Shari'a, banks often need the advice of experienced religious scholars. Therefore, most banks employ a board of Islamic scholars. When confronted with a new problem, the bank should present a solution to the board, and seek its approval. The religious board also administers the zakat-fund. Most boards have an orthodox approach, and try to apply the available Islamic jurisprudence as literally as possible. But where legal definitions are emphasised, too often legal tricks to evade the prohibitions of the Shari'a' are overlooked. Fictitious sale transactions are an example. By manipulating parameters such as the pay-back period, the selling price, etc., a transaction that is completely equal to an interest-bearing loan can be modelled, whereas, in reality, no real transaction occurs at all. In the long run, such tricks may undermine the authority of the Islamic banking movement. To avoid that, a solution must be found for the main problems of Islamic banking. These problems are the topic of the next section.

F. Problems of Islamic Banks

After a rapid expansion in the seventies and early eighties, Islamic banks experienced a setback. The exaggerated optimism of the early years made way for a more realistic view. Success was not only lacking in professional and financial matters. The ideological compromises that were made in practice (see section IV.B) worsened the picture. PLS-financing is only incorporated in the banks' operations on a small scale. The stagnation is mainly caused by the following four problems:

1. ***PLS-financing is unpopular*** with both Islamic banks and clients. For the banks, there are too few attractive projects with an acceptable level of risk. Clients, on the other hand, are unwilling to share too much information and profit with the banks. As a result, PLS-financing attracts many high-risk/low-reward projects, and uncooperative, or even fraudulent, entrepreneurs.

2. ***PLS is not suitable for short-term financing or for the non-profit sector.*** Companies often need finance for short-term liquidity. The administrative procedure of PLS is too lengthy to answer such urgent needs. Furthermore, it is difficult to determine the return on financing liquidity. The same applies to financing the non-profit sector: what is the return of an investment in schools, or in a new highway?

3. ***There is a lack of developed Islamic financial products, institutions and markets.*** Owing to a lack of suitable financial instruments, Islamic banks still experience difficulties in optimising their risk, return and liquidity. Furthermore, the network of Islamic banks is still underdeveloped and too small. Finally, there are no developed Islamic money and capital markets. In cases of liquidity shortages, Islamic banks cannot call upon central banks, because they provide interest-based financing. Recently, Malaysia opened an Islamic inter-bank money market. Initiatives of this kind, more research, and new Islamic financial instruments may cure the 'childhood diseases' of the system.

4. ***Islamic banking in non-Islamic countries is still difficult.*** Western banking legislation requires banks to guarantee the capital of depositors, and ensure them a fixed return. This is directly opposed to the PLS-principle. Furthermore, the valuation of Islamic banks' investment is a difficult and cumbersome task, for which no adequate procedures have yet been developed. As a result, Islamic banks fail to satisfy central banks' strict liquidity and capital adequacy requirements, and have great difficulty in obtaining full banking permission in the West.

It is clear that the problems are mainly concentrated in the field of financing. With respect to deposits, Islamisation has succeeded. If the problem of financing could be overcome, Islamic banking should be able to make a decisive breakthrough.

V. CONCLUSION

In this article, I have given a brief overview of the theory of Islamic banking. Seven of the main principles of Islamic economics have been discussed, and, from these principles, two rules have been deduced. First of all, the prohibition of Riba. Second, to avoid Riba, profit- and loss-sharing has been presented as an alternative way of financing. Two modes of PLS presented in this article are joint ventures and trust financing.

Islamic banks should base their operations on these two contracts. However, we have seen that the reality is different. Islamic banking is only halfway to reaching its objectives. It has managed to Islamise its deposits. But, on the other hand, it has failed to base its financing operations on the idea of profit- and loss-sharing. The main method of financing remains trade financing, which is short-term, predictable and low-risk. Its popularity is mainly due to the risk-aversion of Islamic banks. But one of the aims of Islamic banking is to develop Muslim economies by risk-sharing between partners. Islamic banks therefore do not fully assume their responsibility, because trade financing does not contribute much to development.

Looking toward the future, the main challenge for Islamic banking is to find more successful methods of medium- and long-term financing, based on PLS. The other problems are less complex, and I believe that they will be solved in the course of time. More serious is the problem with PLS-financing. The development of Islamic money and capital markets and the securitisation of project financing will alleviate the problem, but not solve it. Securitisation of PLS-projects would lead to better control of the risk and return of banks' investment portfolios. But Shari'a does not allow banks to minimise their risks while maintaining a return. Risk and return should go hand in hand. Currently, banks' screening procedures are so strict that only a small number of investment proposals pass. On the other hand, easing the procedures would increase the exposure of the banks. A default of an Islamic bank could damage the reputation of the whole movement. It would also add to the scepticism of governments and clients outside the Muslim world. Islamic banks, therefore, have the challenging task of finding workable methods of PLS-financing. Otherwise, Muslim scholars should become more lenient in allowing trade financing as the main method of financing. Because I doubt the latter alternative, I believe that a great deal of work still remains to be done...

Notes

1. The Seven Principles of Islamic Economics, the two economic rules and the two contracts are the author's main framework. They do not represent the actual framework of Islamic banking, which is not confined to this dichotomy.
2. The word "Riba" may be translated into English as "growth", "increase" or "increment".
3. It is important to note that the Orthodox view of Riba was developed in an inflation-free environment.
4. The financing in this case could be partial.
5. Zakat is usually paid to the state in the form of tax. However, in the case of Islamic banking, it may be collected directly from the banks or on a voluntary basis from the clients.

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